

**UNITED STATES BANKRUPTCY COURT**

**DISTRICT OF HAWAII**

In re	)	Case No. 01-4452
	)	Chapter 7
RANDELL A. RILEY,	)	
	)	
Debtor.	)	
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	)	Adv. Pro. No. 02-00013
ECKARD BRANDES, INC.,	)	
	)	
Plaintiff,	)	
	)	
vs.	)	
	)	
RANDELL A. RILEY,	)	
	)	
Defendant.	)	
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**FINDINGS OF FACT AND CONCLUSIONS OF LAW**

This case was tried on February 23, 24, and 25, and March 1, 2004.

Ernest H. Nomura, Esq., and Ellen Onaga. Esq., represented plaintiff Eckard Brandes, Inc. (“EBI”), and Steven Guttman, Esq., and Cori Ann C. Takamiya, Esq., represented defendant Randell A. Riley.

Based on the evidence presented, the court makes the following:

## FINDINGS OF FACT

1. Mr. Riley and Lee T. Kunimitsu were employees of EBI.

While employed by EBI, Mr. Kunimitsu and Mr. Riley formed a general partnership called Kamaaina Pumping (of which they were the sole general partners). Kamaaina Pumping competed with EBI and successfully outbid EBI for a contract with the County of Hawaii.

2. In 1998, Mr. Kunimitsu and Mr. Riley sued EBI in Hawaii state

court, alleging violations of the federal Fair Labor Standards Act and Hawaii's wage and hour statutes. EBI removed the case to the United States District Court for the District of Hawaii and filed a counterclaim, alleging (among other things) that Mr. Kunimitsu and Mr. Riley had breached their fiduciary duty to EBI by competing with EBI while they were EBI's employees.

3. On October 22, 1999, the District Court entered an order

granting in part EBI's motion for summary judgment. The District Court held that Mr. Riley and Mr. Kunimitsu had breached their fiduciary duty to EBI and that "the only remaining question with respect to the duty of loyalty issue was how to ascertain the damages EBI suffered due to Plaintiff's breach." The District Court also dismissed EBI's claims against Kamaaina Pumping.

4. The District Court set the matter for trial on November 18, 1999.

5. Just after the District Court ruled that Mr. Riley and Mr. Kunimitsu would lose the case, and just before the trial at which the District Court would fix the amount of damages, Mr. Kunimitsu and Mr. Riley attempted to put all of their assets and all of Kamaaina Pumping's assets out of the reach of EBI.

a. Mr. Kunimitsu, Mr. Riley, and Kamaaina Pumping executed a UCC-1 financing statement that purported to perfect a security interest on all of their personal property in favor of the law firm that was representing them in the District Court litigation. The financing statement was filed in the Bureau of Conveyances, State of Hawaii, on November 4, 1999.

b. Mr. Kunimitsu and Mr. Riley formed a corporation called Kamaaina Pumping, Inc. The articles of incorporation were signed and filed in the Department of Commerce and Consumer Affairs, State of Hawaii, on November 8, 1999. Kamaaina Pumping, Inc., the successor of the partnership named Kamaaina Pumping, acquired all of the partnership's assets.

c. Kamaaina Pumping, Inc. executed a UCC-1 financing statement which purported to perfect a security interest on all of its personal

property in favor of the law firm that was representing Mr. Riley, Mr. Kunimitsu, and the Kamaaina Pumping partnership in the District Court litigation. The financing statement was filed in the Bureau of Conveyances, State of Hawaii, on November 19, 1999.

6. After the trial, the District Court made findings of fact and conclusions of law (on February 9, 2000) in which the court determined that Mr. Riley and Mr. Kunimitsu must disgorge all compensation that EBI paid them during the period of their disloyalty and all amounts that they received from the Kamaaina Pumping partnership less the value of their labor.

7. On April 19, 2000, Mr. Kunimitsu and Mr. Riley each commenced chapter 7 bankruptcy proceedings. They later converted their cases to chapter 13.

8. On August 7, 2000, this court annulled the automatic stay to permit EBI to prosecute its request for attorneys' fees, costs, and prejudgment interest in the District Court.

9. On September 20, 2000, the District Court entered a final judgment against Mr. Riley in the amount of \$305,698.93 and against Mr. Kunimitsu in the amount of \$284,620.80. The Court of Appeals for the Ninth Circuit affirmed the judgment.

10. On September 25, 2001, this court dismissed the chapter 13 petitions because Mr. Kunimitsu's and Mr. Riley's debts exceeded the eligibility maxima under 11 U.S.C. § 109(e).

11. On November 14, 2001, Mr. Kunimitsu and Mr. Riley each filed chapter 7 petitions.

12. EBI commenced this adversary proceeding by filing a timely complaint objecting to Mr. Riley's discharge.

13. Mr. Kunimitsu and Mr. Riley formed Kamaaina Pumping, Inc., and transferred the partnership's assets to it for the purpose of hindering, delaying, or defrauding EBI.

a. When Mr. Riley and Mr. Kunimitsu arranged for the transfer, they were engaged in litigation and they knew that they had lost. Mr. Riley and Mr. Kunimitsu formed the corporation and transferred the business assets to it after the District Court ruled against them on the issue of liability and just before the trial on damages. The timing of the incorporation and transfer makes their fraudulent intent clear.

b. Mr. Riley and Mr. Kunimitsu transferred the assets to an entity over which they held complete dominion and control. They were (and are) the sole shareholders, directors, and officers of the corporation. They were able to

continue to use the assets for personal purposes, such as the payment of personal child support obligations, personal attorneys' fees, personal taxes, and certain non-business travel and entertainment expenses.

c. Mr. Riley and Mr. Kunimitsu were in poor financial condition at the time of the transfer. They had no significant assets apart from their interests in the business and faced the near certainty of a ruinous judgment in favor of EBI.

d. Mr. Riley and Mr. Kunimitsu arranged for the transfer of substantially all of their assets, leaving virtually nothing for their creditors. Their interest in the business' assets was their only significant asset.

e. Mr. Kunimitsu and Mr. Riley failed to observe the requisite corporate formalities for Kamaaina Pumping, Inc. They did not conduct annual meetings of the directors and shareholders (or, if such meetings were held, they failed to keep minutes or other records of the meetings).

f. Mr. Riley and Mr. Kunimitsu's attempt to explain the incorporation and transfer of assets is not convincing. Mr. Riley and Mr. Kunimitsu both testified that they formed Kamaaina Pumping, Inc., for tax reasons. They claim that their accountant, Ronald Dolan, told them that they would pay less taxes if they incorporated the business. This testimony is not

credible. Although Mr. Riley and Mr. Kunimitsu called Mr. Dolan to testify at trial, they did not ask him to confirm that he had advised them to form a corporation for tax purposes (or any other purposes). Further, the incorporation of a business usually does not reduce the total amount of tax paid in respect of the business' income.

Based on the foregoing findings of fact, the court makes the following:

### CONCLUSIONS OF LAW

1. Section 727(a)(2) provides that “the court shall grant a discharge, unless . . . the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed . . . property of the debtor, within one year before the date of the filing of the petition . . . .”

2. Courts generally construe section 727 liberally in favor of debtors and strictly against parties objecting to discharge. In re Bernard, 96 F.3d 1279, 1281-82 (9th Cir. 1996).

3. A party objecting to discharge must prove that there was: “(1) a disposition of property such as transfer or concealment, and (2) a subjective intent

on the debtor's part to hinder, delay or defraud a creditor.” In re Wills, 243 B.R. 58, 65 (B.A.P. 9th Cir. 1999). The plaintiff must establish all of the elements of a section 727(a)(2)(A) claim by a preponderance of the evidence. In re Cox, 41 F.3d 1294, 1297 (9th Cir. 1994); In re Lawler, 141 B.R. 425, 429 (B.A.P. 9th Cir. 1992).

4. The incorporation of Kamaaina Pumping, Inc., and the transfer of assets to it constitutes a “transfer” within the meaning of section 727(a)(2). The term transfer “means every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor’s equity of redemption.” 11 U.S.C. §101(54). “Under this definition, any transfer of an interest in property is a transfer, including a transfer of possession, custody, or control even if there is no transfer of title, because possession, custody, and control are interests in property.” In re Bernard, 96 F.3d at 1282. The transfer to the corporation of assets in which the debtors had partnership interests constitutes a “transfer” of “property of the debtor” for purposes of section 727(a). See In re Adams, 31 F.3d 389, 394 (6th Cir. 1994) (corporate accounts receivable were “property of the debtor” for purposes of section 727(a)(2) where the debtor controlled the corporation).



5. An intent to hinder, delay or defraud creditors is rarely subject to direct proof. In re Towe, 147 B.R. 545, 548 (Bankr. D. Mont. 1992).

“Accordingly, such intent can be established by circumstantial evidence, or by inferences drawn from a course of conduct on the part of a debtor.” Id.

Circumstantial factors that may establish fraudulent intent (the so-called “badges of fraud”) include:

(1) a close relationship between the transferor and the transferee; (2) that the transfer was in anticipation of a pending suit; (3) that the debtor was in poor financial condition at the time of the transfer; (4) that the debtor transferred all or substantially all of his property; (5) that the transfer left no assets to satisfy creditors; and, (6) that the debtor received inadequate consideration.

In re Wills, 243 B.R. at 63. Not all of these factors need to be present in order to determine fraudulent intent. Id. Mr. Riley and Mr. Kunimitsu had the requisite intent.

6. Although Mr. Riley and Mr. Kunimitsu incorporated Kamaaaina Pumping and apparently transferred the partnership assets to it more than one year before they commenced their pending chapter 7 bankruptcy cases, the one-year requirement of section 727(a)(2) is nonetheless satisfied for two reasons.

a. The one-year lookback period of section 727(a)(2) is subject to equitable tolling. The one-year period is a “limitations period” because “it prescribes a period within which certain rights (namely, priority and nondischargeability in bankruptcy) may be enforced.” Young v. United States, 535 U.S. 43, 46 (2002). “It is hornbook law that limitations periods are ‘customarily subject to ‘equitable tolling,’ . . . unless tolling would be ‘inconsistent with the text of the relevant statute’ . . . Congress must be presumed to draft limitations periods in light of this background principle . . . . That is doubly true when it is enacting limitations periods to be applied by bankruptcy courts, which are courts of equity and ‘appl[y] the principles and rules of equity jurisprudence.’” Id. at 49-50 (citations omitted). In Young, the Supreme Court held that the three-year lookback period for determining the priority and nondischargeability of taxes is tolled during the pendency of a prior bankruptcy case regardless of “whether the [prior] petition was filed in good faith or solely to run down the lookback period.” Id. at 51. The reasoning of Young applies with equal force to section 727(a)(2). In re Womble, 289 B.R. 836, 851-52 (Bankr. N.D. Tex.), aff’d Womble v. Pher Partners, 299 B.R. 810 (N.D. Tex. 2003).<sup>1</sup>

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<sup>1</sup> Melancon v. Jones, 292 B.R. 555 (Bankr. E.D. Tex. 2003), cited by the debtors, states that the one-year period is not tolled during a prior bankruptcy case. Melancon is not persuasive because the opinion provides no analysis or discussion and does not even mention Young. The debtors also argue that the equitable tolling argument should be ignored because EBI’s complaint does not mention it. The debtors are wrong. A limitations period creates an affirmative defense that the defendant must assert in the answer but the plaintiff need not (and

Excluding the time during which the chapter 13 cases were pending, the incorporation of Kamaaina Pumping, Inc., and the transfer of partnership assets to it occurred less than a year prior to the commencement of the current chapter 7 cases.

b. The Court of Appeals for the Ninth Circuit has adopted the “continuing concealment” doctrine. See In re Lawson, 122 F.3d 1237 (9th Cir. 1997). Under the “continuing concealment” doctrine, section 727(a)(2) applies if “a debtor’s prior concealment of an interest in an asset continues, with the requisite intent, into the year before the bankruptcy.” In re Towe, 147 B.R. at 548. “[A] transfer made and recorded more than one year prior to filing may serve as evidence of the requisite act of concealment where the debtor retains a secret benefit of ownership in the transferred property within the year prior to filing.” In re Lawson, 122 F.3d at 1240. The “continuing concealment” doctrine is not limited to real property. In re Shala, 251 B.R. 710, 714 (N.D. Ill. 2000). The transfer of the partnership’s assets to a newly formed corporation just after the District Court ruled against the debtors on the issue of liability and just before the trial to establish damages is merely the beginning point for this court’s analysis. During the year before the chapter 7 filings, Mr. Riley and Mr. Kunimitsu continued to use the money ostensibly belonging to the corporation to pay personal expenses, including alimony, child support, family vacations, and personal

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usually should not) anticipate in the complaint.

attorney's fees. Mr. Riley and Mr. Kunimitsu's retention of complete dominion and control over the assets despite the ostensible transfer constitutes a "continuing concealment."

7. Mr. Riley and Mr. Kunimitsu argue that equitable tolling and the continuing concealment doctrine should not apply because EBI knew about the transfers and could have taken action against Kamaaina Pumping, Inc., despite their personal bankruptcies but did not do so. This ignores the rule that "lack of injury to creditors is irrelevant for purposes of denying a discharge in bankruptcy." In re Adeeb, 787 F.2d 1339, 1343 (9th Cir. 1986); see In re Wills, 243 B.R. at 65. "For purposes of continuing concealment, it is not the secrecy of a transfer or of a retained interest that matters. . . . Rather, '[t]he transfer of title with attendant circumstances indicating that the [debtor] continues to use the property as his own is sufficient to constitute concealment.'" In re Womble, 289 B.R. at 845-46 (quoting In re Sullivan, 204 B.R. at 939 (Bankr. N.D. Tex. 1997)). A debtor who deliberately defrauds his creditors is not entitled to a discharge even if the creditors could have sought remedies.

8. EBI alleges that Mr. Riley and Mr. Kunimitsu are not entitled to a discharge pursuant to section 727(a)(4) because they allegedly made false statements on their schedules and statements of financial affairs. Because the debtors are not

entitled to a discharge by virtue of section 727(a)(2), these claims are moot and need not be decided.

9. An appropriate separate judgment will be issued.

DATED: Honolulu, Hawaii, April 20, 2004.



*/s/ Robert J. Faris*  
**United States Bankruptcy Judge**